Tax and the City Briefing

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Jersey, Guernsey and the Isle of Man consult on substance requirements for corporate residence in response to EU concerns about the lack of a need for a business to demonstrate economic substance in order to be tax resident. The government acknowledges that the input tax deduction rules for financial services supplied to the EU may have to change in the event of a no deal Brexit, but how it would change is yet to be announced. The draft discussion document published by the OECD's Working Party 6 in July highlights the divergence of views on the transfer pricing aspects of financial transactions. The CJEU's decision in the Bulgarian case of *TTL EOOD*, that irrecoverable default interest charged on income tax not withheld pending treaty relief is unlawful, raises questions about the EU compatibility of a similar rule in the UK.

Crown dependencies consult on substance requirements for corporate residence

Jersey, Guernsey and the Isle of Man each propose to introduce substance requirements for company tax residence. The consultations launched in August were in response to concerns expressed by the EU Code of Conduct Group (Business Taxation) (COGC) about the lack of a need for a business to demonstrate economic substance in order to be tax resident in any of these three jurisdictions. The COGC were concerned that this increases the risk that profits registered in a jurisdiction are not commensurate with economic activities and substantial economic presence.

Substance requirements will be imposed on companies undertaking "relevant activities". It is anticipated that the substances requirements will apply for accounting periods beginning on or after 1 January 2019. "Relevant activities" have been derived from the categories of geographically mobile income identified by the Forum for Harmful Tax Practices as follows: banking, insurance, fund management, financing & leasing, headquarters, shipping, holding company activities, and intellectual property. Detailed guidance will be required in order to allow companies to identify whether they are carrying on "relevant activities". The Jersey consultation document shows that some of the requirements are tailored to specific relevant activities (section 6.2) but others are common to all the activities (sections 6.1 and 6.3). There are enhanced substance requirements for IP income generating companies and reduced substance requirements for collective investment vehicles.

It is anticipated that the minimum information that companies carrying on "relevant activities" will be required to submit through their corporate income tax return for the 2019 year of assessment onwards is: business activity; amount and type of gross income; amount and type of expenses and assets; premises; and the number of employees, specifying the number of full time (equivalent) employees. There is a proposed hierarchy of sanctions for companies that fail to comply with the applicable substance requirements.

Any company carrying on business activities in Jersey, Guernsey or the Isle of Man should follow the proposals carefully to establish whether their activities are "relevant activities" and if so, what substance requirements apply.

VAT consequences for financial institutions of no deal Brexit

Unsurprisingly, the government's notice *VAT for businesses if there's no Brexit deal* acknowledges that the input tax deduction rules for financial

services supplied to the EU "may have to change". Under current rules, input tax attributable to the supplies of insurance and financial services to the EU is not deductible, whereas input tax attributable to supplies of such services to non-EU countries is deductible. Upon leaving the EU, there would be no reason to treat services supplied to EU and to non-EU countries differently. Whereas insurance and financial services providers hope the difference would be removed in their favour, it would be expensive for the government to permit deductions for input tax attributable to the supplies of insurance and financial services to the EU. The notice promises to update businesses with further information in due course.

Transfer pricing aspects of financial transactions

Draft financial transactions guidance was originally expected in 2017 but was delayed because of the number of contentious issues. The draft guidance published by the OECD Working Party 6 (WP6) in July is a non-consensus version that highlights the divergence of views and requests wider input to help narrow the areas of disagreement. A consensus draft is expected to be produced in late 2018 or early 2019.

WP6 has been working on this discussion draft under the mandate of the Report on Actions 8-10 of the BEPS Action Plan. The purpose of the discussion draft is to provide guidance for determining whether the conditions of certain financial transactions between associated enterprises are consistent with the arm's length principle. The guidance is intended to apply to all types of business, including financial services.

A key issue upon which there is no consensus is whether the arm's length principle should be focused on pricing only (something the US argues strongly for) or if it is also relevant to the characterisation of an instrument, such as an intra-group loan, as debt or equity. The draft guidance deals with this difference in opinion by acknowledging that although one approach is to apply the arm's length principle to determine whether a debt instrument should be respected as debt, other approaches may be taken under domestic legislation to address the issue of the capital structure before pricing the interest on the debt so determined. Accordingly, the discussion draft provides guidance for use of the arm's length principle for characterisation purposes but it does not mandate this as the only approach. The problem with allowing jurisdictions to choose whether or not to apply the arm's length principle or to rely instead on non-transfer pricing rules, such as safe harbours, is that it can lead to different conclusions being reached on the characterisation of the instrument with resulting double taxation.

Feedback is requested in several other areas, including on the effect of group membership on the pricing of intra-group loans. The draft guidance asks questions about the relevance of a group-wide credit rating when pricing a group entity's debt and how such a group-wide credit rating could be determined in the absence of a publicly-available rating, for example in the case of privately owned groups. Views are invited on whether there should be a rebuttable presumption that each group member has the same credit rating as the global group. It would be for either the taxpayer or the tax administration to rebut the presumption to establish a different credit rating for a particular group entity. This new approach is intended to promote tax certainty and tax compliance but it would be contrary to the arm's length principle and it is not clear it would be a simplification. Another issue for debate is the appropriateness of adjusting a standalone credit rating of an entity to take into account the implicit support, or the "halo" effect, of passive association with the rest of the group when determining the terms and conditions an independent lender would offer.

Cash pooling is another area where the guidance seeks commentators' views. Three possible approaches are suggested for the allocation of cash pooling benefits to the participating cash pool members. Views are invited on the suitability of these approaches to different circumstances and

on whether other approaches are used in practice to remunerate the cash pool members.

Two other areas where interesting issues remain are financial guarantees and captive insurance. Detailed questions are asked about each of these areas, with requests for examples of what happens in practice.

The closing date for comments on the discussion draft was 7 September. The comments will be made publicly available. No doubt WP6 will have plenty of work to do reviewing the input received and smoothing out as any many areas of disagreement as they can.

TTL EOOD: late payment interest on withholding tax pending treaty relief

TTL EOOD C-553/16 is a Bulgarian case involving late payment interest on withholding tax (WHT) pending treaty relief. Under the Bulgarian legislation, a Bulgarian company paying out income to a non-resident company which does not have a Bulgarian permanent establishment is required to pay interest (in respect of tax not withheld) until the day on which the non-resident company furnishes evidence that the requirements for treaty relief are satisfied. Even where it is subsequently shown that no WHT was required because of the treaty, the Bulgarian company is still liable for the late payment interest. There is no provision for reimbursement of the late payment interest in the event it is shown that no WHT is in fact payable. The Court of Justice found this to be an unjustified restriction on the free movement of services.

The UK has a similar rule in relation to late payment interest where a borrower has failed to withhold tax on payments of interest to an overseas lender pending an application for treaty relief. Until a direction to pay gross is obtained from HMRC, a borrower must withhold tax on interest paid to the lender which is claiming treaty relief. If the tax is not withheld, interest is chargeable under TMA 1970, s87 even if it is subsequently shown that the conditions for treaty relief are met. Whereas any tax actually withheld before the direction to pay gross may be reclaimed, HMRC's *International Manual* INTML413230 emphasises that there is no relief or discharge from the s87 interest charge on the payer in relation to its failure to withhold pending the direction. This case might have implications for the UK's default interest rule, at least in relation to intra-EU payments before the UK leaves the EU.

What to look out for:

- The EU trial for VAT ruling requests in complex cross-border cases comes to an end on 30 September.
- 1 October is the entry into force date for the UK of the BEPS Multilateral Instrument (MLI). The MLI changes will only be brought into effect for UK treaties which are covered by the MLI and where the MLI has also come into effect for the other treaty partner and will only apply to the relevant treaty to the extent that both the UK and the other treaty partner have agreed. At the time of writing, the first of the UK's tax treaties for the MLI to apply are New Zealand, Poland, Serbia, Slovenia and Sweden. The MLI changes will apply in the UK to these treaties with effect from: 1 January 2019 for taxes withheld at source, 1 April 2019 for corporation tax, and 6 April 2019 for income tax and capital gains tax.

- 2 October is the closing date for the consultation on amending HMRC's civil information powers. The government seeks comments on whether aspects of the information powers enacted by Finance Act 2008, schedule 36 are still relevant, and on some specific areas being considered for improvement. One of the proposals is the alignment of third party notices with taxpayer notices by removing the requirement for HMRC to seek approval from either the tribunal or the taxpayer before issuing the third party notice. An alternative proposal, targeted at financial institutions, is the introduction of a separate rule for third party notices for banking information held by financial institutions so HMRC would be able to get hold of this information quickly and without the need for tribunal approval. The banking information would, however, have to be reasonably required to check a taxpayer's tax position. Banking information would be defined to include bank statements, information about transactions on the account and information held about the legal and beneficial ownership of the account (e.g. Know Your Customer information).

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